

BEFORE THE STATE TAX APPEAL BOARD

OF THE STATE OF MONTANA

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COLLINS CONSTRUCTION CO.	)	
	)	DOCKET NO.: PT-1994-36 &
Appellant-Respondent,	)	PT-1995-39R
	)	
-vs-	)	
	)	ORDER ON REMAND
	)	
THE DEPARTMENT OF REVENUE	)	FINDINGS OF FACT,
OF THE STATE OF MONTANA,	)	CONCLUSIONS OF LAW,
	)	ORDER and OPPORTUNITY
Respondent-Appellant.	)	<u>FOR JUDICIAL REVIEW</u>

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The above-entitled appeal came before the Montana State Tax Appeal Board (the Board) for hearing on remand on the 27th day of January, 1998, in the City of Helena, Montana, pursuant to the Remand Order of Judge Jeffery Sherlock, Montana First Judicial District, Lewis and Clark County. The notice of the hearing was given as required by law. The Department of Revenue (DOR) was represented by attorney Pat Dringman and Jim Fairbanks, Region III Manager. The taxpayer was represented by agent Don McBurney. At this time and place, evidence and testimony was presented.

### **STATEMENT OF THE ISSUES BEFORE THE BOARD**

The District Court Order of Remand instructed this Board:

- to establish the value of the subject property based upon the income approach to value; and, in the event it is determined the DOR is unable to apply the income approach to value, state the reasons why the income approach could not be used; and
- to make specific findings on the issue of whether the petitioner is entitled to consideration of the governmental restrictions in determining market value for the subject property under the cost method of appraisal and, if so, the decision is to reflect how the governmental restrictions are factored into its valuation.

### **FINDINGS OF FACT**

1. Due, proper and sufficient notice was given of this matter, the hearing hereon, and of the time and place of the hearing. The parties were afforded opportunity to present further evidence and testimony related to the Order of Remand.

2. The market value for the subject property was determined by the DOR by the cost approach to value.

3. This Board's order dated December 21, 1995 directed the DOR to change the quality of construction from "good" to "average".

4. The Board's order resulted in a market value

reduction for the improvements from \$1,358,100 to \$1,139,000.

5. Petition for Judicial Review was filed with the First Judicial District on February 15, 1996. Collins Construction Co., (Collins Missoula Apartments, A Limited Partnership, C. Dale Collins, General Partner) v. Department of Revenue of the State of Montana, Cause No. BVD-96-215.

6. The Board's Order was remanded for further evidentiary findings on November 13, 1997. Collins Construction Co., (Collins Missoula Apartments, A Limited Partnership, C. Dale Collins, General Partner) v. Department of Revenue of the State of Montana, Cause No. BVD-96-215.

7. Exhibits presented in the hearing on remand have been prefaced by the letter "R" to differentiate exhibits from the previous hearing.

#### **DOR CONTENTIONS**

1. State's exhibit A from the original hearing illustrates that a value based on the income approach was determined when the property was appraised in 1993. This value of \$1,974,000 was suppressed as the DOR appraiser placed more confidence on the value determined by the cost approach.

2. DOR exhibit R-A is an income approach to value for the subject property. Mr. Fairbanks testified that 80% of

the income of the original income model was used to arrive at potential gross income (PGI). The expenses were adjusted upward 120% from the original income model from \$1.20 per square foot to \$1.44 per square foot. The net operating income (NOI) was capitalized at 10.97% resulting in a market value indication of \$1,361,301.

3. DOR exhibit R-B, entitled "HUD Low Income Projects/Financing", in part comes from discussions with Debra Dahl of the "Housing and Urban Development Multifamily Assets Management Division". In summary this exhibit states:

Ms. Dahl detailed that a HUD section 236 loan was granted the Collins Construction Company's Sentinel Village project in 1971. Terms of the 40-year HUD loan provided for an effective 1% loan (bought down by HUD from then a market rate of 8%, as enticements to enter the program). Additionally, a 20-year prepayment option would allow the owner to break from the program and rent to non low income renters, or, even sell as condominiums if desired. (emphasis added)

As the twenty-year prepayment deadline approached, HUD attempted to alter original agreements to require investors to continue low income subsidized renting. In compromise of the accusation that such HUD "rule changing after the fact" might be considered a taking of property rights, TITLE 6 was written. TITLE 6, a *Low Income Afford ability and Low Income Ownership Act* provided for the owner to "cash out" by refinancing (at market rates) up to 120% of the market rental rates, established by two appraisals, less mortgage liability and identified required repairs. Ms. Dahl also explained that excess management costs are subject to special HUD subsidies, but could not identify terms of applications with the subject property.

Collins/Sentinel village (sic) representative Don McBurney completed and appraisal of the subject property for \$1.75 million as of November 11, 1992, for refinancing purposes detailed above.

4. Mr. Fairbanks testified that expenses for the subject property, whether expressed on a price per square foot basis or as a percentage of the effective gross income would not differ substantially than those of a market apartment complex.

5. DOR exhibit R-F, is a portion of an article titled "Subsidized Housing: An Assessor's Viewpoint". Mr. Fairbanks referenced portions of this article:

"...By recorded contract, the government pays the reduction from the market interest rate of 9.5 percent to 1 percent. This is the government subsidy paid in exchange for the tenants not exceeding the established income requirements. This subsidy is a direct benefit of ownership as determined in the bundle of rights and should be considered in the valuation process..."

"...Two choices are available to value this subsidy: (1) use a reduced capitalization rate that reflects the 1 percent actual interest paid with the actual net income or (2) add the subsidy to actual net income as above and use the market capitalization rate with this total income..."

6. DOR exhibit R-G illustrates the financing benefit:

#### HUD FINANCING BENEFIT ADJUSTMENTS

<u>LOAN AMOUNT</u>	<u>TERM</u>	<u>RATE</u>	<u>MONTHLY PAYMENT</u>	<u>ANNUAL PAYMENT</u>
\$793,900.00	40 YR	8.5%	\$5,809.30	\$69,711.60
\$793,900.00	40 YR	1.0%	\$1,933.97	<del>-\$23,207.64</del>
YEARLY BENEFIT:				\$46,503.96

7. DOR exhibit R-H is an income approach to value for the subject property. Mr. Fairbanks testified that the actual income was used and the financing benefit of \$46,504 was added to arrive at the potential gross income (PGI). Mr. Fairbanks testified that the expenses were further adjusted to recognize that the utilities are paid by the landlord, therefore, expenses were adjusted upward 125% from the original income model from \$1.20 per square foot to \$1.50 per square foot. The net operating income (NOI) is capitalized at 10.995% resulting in a market value indication of \$1,389,999.

7. Management is determined to be 7% of the effective gross income, which is consistent with other rental property in the area.

8. Mr. Fairbanks testified that the value determined from the income approach provides support for the value determined from the cost approach.

9. Mr. Fairbanks testified that a loss in value

from the governmental restriction would be reflected in the difference in value from the cost and income approaches to value. There is no indication that economic obsolescence has affected the value of the subject property.

10. Mr. Fairbanks testified that the recognition of any additional subsidies or benefits to the property are reflected in the application of the expenses from the DOR's original income model rather than the actual expenses, as demonstrated on the taxpayers profit/loss statement.

11. Mr. Fairbanks testified that the income approaches presented (ex. R-A & R-H) provide support for the DOR's value derived from the cost approach; therefore, the DOR's cost value of \$1,400,360 is the total market value of the subject property.

#### **TAXPAYER'S CONTENTIONS**

1. Mr. McBurney testified that the DOR's exhibit R-A, with respect to the 20% downward adjustment to the income is totally arbitrary.

2. Mr. McBurney testified that "market rate or market based" multi family apartment projects have expense ratios range from 37% to 45% and the subject property's expense ratio is in the 70% range.

3. Mr. McBurney contends that the overall capitalization utilized by the DOR is understated.

4. Mr. McBurney testified that the mortgage buy down by HUD to 1% is not an enticement because it does not accrue to the owners of the property. This buy down is a benefit which flows through to the low income tenants in the form of lower rents.

5. Mr. McBurney testified that he did, in fact, appraise the subject property for 1.75 million dollars in 1992.

This value indication for the property reflects "Preservation Value". That appraisal is not applicable in this appeal since it was done to a different value standard.

6. Mr. McBurney testified that the owners of the subject property do not have the full "bundle of rights" since the property cannot achieve market rents; therefore, the property has an encumbrance placed on it by the government.

7. Mr. McBurney requested the Board take administrative notice of the evidence and testimony presented in PT-1994-50, Grandview Plaza.



### **BOARD'S DISCUSSION**

The Court's Remand Order has directed this Board to address the following:

- to establish the value of the subject property based upon the income approach to value; and, in the event it is determined the DOR is unable to apply the income approach to value, state the reasons why the income approach could not be used; and
- to make specific findings on the issue of whether the petitioner is entitled to consideration of the governmental restrictions in determining market value for the subject property under the cost method of appraisal and, if so, the decision is to reflect how the governmental restrictions are factored into its valuation.

The Board has taken administrative notice of the evidence and testimony presented in the remand hearing, *Grandview Plaza v. DOR*, PT-1994-50, as it pertains to the Order of Remand.

Neither party presented to the Board sales of low income housing projects other than a distressed sale in Cut Bank, Montana as testified to by Mr. McBurney. A direct sales comparison could not be made between market rate and low income housing projects to determine if or how the government encumbrances/restrictions have affected the market value; therefore, this Board has taken the approach of examining the market value determination from an income approach and

comparing that to the value indication from the cost approach.

The DOR has presented this Board with three separate values derived from the income approach to value. The original income value of \$1,974,400 was presented in a DOR exhibit at the original hearing and this value was suppressed by the DOR appraiser (exhibit A). It was the appraiser's opinion that the value from the cost approach was the best indication of value.

In preparation for this remand hearing, the DOR established two additional values from the income approach: exhibit R-A - \$1,361,301 and R-H - \$1,389,999.

DOR's exhibit R-A is an adjusted version of the original income value (exhibit A). The unit rents were adjusted downward by 20% while the expenses were adjusted upward 20%. The value indication from this exhibit does provide support for the cost value, but the income and expenses can be adjusted by any selected amount to arrive at a value indication. The Board holds little confidence in this exhibit because of the arbitrary adjustments and no market data was offered for support of those adjustments.

In exhibit R-H, the DOR recognized the rents or actual income collected for the year 1993. In reviewing this exhibit the Board discovered the DOR had not included the miscellaneous income when calculating the potential gross income. The DOR also understated the square footage which is identified as 48,992 SF. Exhibit R-A and the property record card show a square footage figure of 49,176 SF. As a result, total expenses are understated on exhibit R-H when expenses are calculated on a price per square foot. The effective tax rate on exhibit R-A is 1.97% and on exhibit R-H the tax rate is 1.995%. It is this Board's opinion the effective tax rate should be consistent when utilizing this approach and for each exhibit, therefore, an effective tax rate of 1.97% will be considered.

The taxpayer's profit and loss statement shows a management fee of 11%. The DOR applied a management fee of 7%. The Board agrees with Mr. McBurney's argument that the government involvement requires a management fee higher than that which is typical; therefore, a management fee of 11% is more appropriate for the subject property. The following table is an illustration

of the various values presented to this Board:

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Exhibit#	DOR  R-A	Comments: income &  expense  adjustments.		DOR  R-H	Comments: Actual  DOR exhibit.		DOR reported original income  model from exhibit A.		
Expenses(SF)	\$1.20	Management - 7%		\$1.50	Management - 7%		Value	\$/per apt	\$/SF
Size (SF)	49,176	60 apt units		48,992 *	60 apt units		\$1,974,400	\$32,907	\$40.15
	Apts	Mo. Rent		Apts	Mo. Rent		McBurney Preservation value		
1 bedroom	12	\$325		12	\$225				
2 bedroom	36	\$425		36	\$275		Value	\$/per apt	\$/SF
3 bedroom	12	\$500		12	\$317		\$1,750,000	\$29,167	\$35.59
INCOME									
Monthly rental income	\$25,200			\$16,404					
Income Adjustment	80%			none					
Total monthly rental income	\$20,160			\$16,404					
Annualized	X 12			X 12					
Total	\$241,920			\$196,848					
Other income	\$0			\$6,398					

Financing benefit	\$0			\$46,504		
Potential Gross Income (PGI)	\$241,920			\$243,352		
Occupancy	98%			100%		
Effective Gross Income (EGI)	\$237,082			\$243,352		
<b>EXPENSES</b>	120%	% of EGI	\$/SF	125%	% of EGI	\$/SF
Management	(\$16,934)	7%	\$0.34	(\$17,035)	7%	\$0.35
Expenses	(\$70,813)	30%	\$1.44	(\$73,488)	30%	\$1.50
Total Expenses	(\$87,747)	37%	\$1.78	(\$90,522)	37%	\$1.85
Net Operatin Income (NOI)	\$149,335	63%	\$3.04	\$152,830	63%	\$3.12
<b>CAPITALIZATION</b>						
Capitalization rate (OAR)	9.00%			9.00%		
Effective tax rate	1.97%			1.995%		
Total Rate	10.97%			10.995%		
<b>Value Indications</b>		\$/per apt	\$/SF		\$/per apt	\$/SF
Income - NOI/Total rate	\$1,361,301	\$22,688	\$27.68	\$1,389,999	\$23,166	\$28.37
Cost Value	\$1,400,360	\$23,339	\$28.48	\$1,400,360	\$23,339	\$28.58

The Board does not agree with Mr. McBurney's argument that the mortgage buy-down to 1% by HUD is not a benefit to the property. This mortgage buy down is one component of the HUD 236 Program which assists in the development and availability of low income housing. It is evident that the property's income could not cover the debt service without this subsidy. The HUD 236 Program needs to be analyzed as a whole when valuing a property of this type. Each component of the HUD 236 Program has an impact on the property's market value. It is the Board's opinion that recognizing only the rent restrictions and excluding the mortgage subsidy could be viewed an error or omission in determining the market value.

Taxpayer's exhibit 11, the Polton appraisal, is an appraisal for Grandview Plaza located in Great Falls. This property is similar to the subject property with respect to the HUD Section 236, Low-Income Program. Mr. McBurney presented this exhibit to illustrate the methodology utilized by Mr. Polton. In his report, Mr. Polton determined tangible and intangible values. The definitions of these values used in the report are as follows:

Tangible Value - Property that can be perceived with the senses; includes land, fixed improvements, furnishings, merchandise, cash, and other items of working capital used in an enterprise.

Intangible Value - A value that cannot be imputed to any part of the physical property, e.g. the excess value attributable to a favorable lease or mortgage, the value attributable to goodwill.

His appraisal states further:

...the Appraisal Standards Board of the Appraisal Foundation note the distinction in the [Proposed Advisory Opinion - 11-01-94] for the Uniform Standards of Professional Appraisal Standards under the section entitled Property Rights Issues. The Proposed Advisory Opinion States:

[Subsidies that create affordable housing may also create intangible property rights in addition to real property rights and/or restrictions that modify real property rights.]

Further research on this issue of valuing low income properties or subsidized housing, Uniform Standards of Professional Appraisal Practice (USPAP), Advisory Opinion AO-14 states:

SUBJECT: Appraisals for Subsidized Housing

Property Rights Issues

Subsidies and incentives that encourage housing for low- and moderate-income households may create intangible property rights in addition to real property rights and also create restrictions that modify real property rights. The appraiser should demonstrate the ability to discern the differences between the real and intangible property rights and value the various rights involved.

Low-Income Housing Tax Credits (LIHTCs) are an example of an incentive that results in intangible property rights that are not real property but might be included in the appraisal. Project-based rent subsidies are an example of a subsidy accompanied by restrictions that modify real property rights. Appraisers should be aware that tenant-based rent subsidies do not automatically result in a property right to the owner or developer of subsidized housing. (emphasis added)

Standards Rule 1-2(e) allows the inclusion of intangible assets that are not real property in the appraisal and, if they are significant to the overall value, the intangible value should be reported separately. One way to measure the significance of the intangible assets is to estimate the value including the intangibles and to compare the results with an estimate of value excluding the intangibles. (emphasis added) Additional guidance is provided in the Comment section of Standards Rule 1-2(e).

A critical factor in all subsidized housing appraisals is the analysis of whether or not the various subsidies, incentives and restrictions remain with the real property following a sale or foreclosure and are marketable property rights to be included in the appraisal. (emphasis added)

#### Value Definition Issues

The value definition in any appraisal is a controlling factor of the bundle of rights to be considered in the valuation. Standards Rule 1-2(b) requires an appraiser to define the value being considered. Standards Rule 1-2(b) further states, if the value to be estimated is market value the appraiser must clearly indicate whether the estimate is the most probable price:

- I. in terms of cash; or
- ii. in terms of financial arrangements equivalent to cash; or
- iii. in such other terms as may be precisely defined; if an estimate of value is based on submarket financing with unusual conditions or incentives, the terms of such financing must be clearly set forth, their contributions to or negative influence on value must be described and estimated, and the market data supporting the valuation estimate must be described and explained. (emphasis added)

If the appraisal of a subsidized housing assignment is for market value, the appraiser must determine if requirement (I), (ii), or (iii) above applies to the specific definition selected or required by the client. The appraiser can then determine if the programs and intangible assets created by the programs affecting the subject property qualify under the selected or required market value definition. This determination requires competent knowledge of the programs and whether the programs qualify under (I), (ii), or (iii) above.



USPAP does not mandate market value appraisals, but does require that the value be defined. If the defined value for the total property (real property and intangible assets) is not market value, then (I), (ii), and (iii) above may not be applicable. Additional guidance is provided in the Comment sections of Standards Rules 1-2(b) and 1-2(e).

The Glossary of USPAP recognizes there are numerous definitions of market value. The Glossary includes one commonly used market value definition, which is the definition agreed upon by agencies that regulate federal financial institutions in the United States. Implicit in this definition is the consummation of a sale under a condition that the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

In appraisal of subsidized housing the value definition selected or required by the client and the reporting techniques should be discussed with the client prior to the acceptance of the assignment because the analyses may be based on general market terms, subsidized housing submarket financing with unusual conditions or incentives, both, or some other defined premise.

Because Standards Rule 1-2(b) also states that the terms of submarket financing or financing with unusual conditions or incentives must be clearly set forth, their contributions to or negative influence on value must be described and estimated. (emphasis added)

Subsidies and incentives should be explained in the appraisal report and their impact on value, if any, needs to be reported in conformity with the Comment section of Standards Rule 1-2(e), which states "Separate valuation of such items is required when they are significant to the overall value (emphasis added)

Appraisers should be aware that appraisal of subsidized housing usually requires more than one value analysis predicated on different scenarios. In appraisal of subsidized housing, value conclusions that include the intangibles arising from the programs will also have to be analyzed under a scenario without the intangibles in order to measure their influence on value and report the results without misleading the intended user. (emphasis added)

Market Analysis Issues

Certain specific steps should be taken when appraising subsidized property. Research with housing organizations and public agencies should be completed to find appropriate data on financing, rental and occupancy restrictions, resale restrictions, and sales of comparably subsidized or restricted properties. Knowledge of the general markets and the subsidized housing sub-markets should be evident in all analyses. The market analyses should also address the subject's ability to attract a sufficient number of subsidized tenants. Reversion projections should be based on interviews with market participants; any factual information from developments that have reached the expiration of their subsidies, incentives and restrictions; and other relevant information.

#### Legal Jurisdictions

Appraisers should be aware that some jurisdictions may have laws, administrative rules, regulations or ordinances that stipulate requirements in the valuation of subsidized housing within their jurisdiction. If so, appraisers, who are bound to utilize these requirements, comply with USPAP under the JURISDICTIONAL EXCEPTION.

This Advisory Opinion is based on presumed conditions without investigation or verification of actual circumstances. There is no assurance that this Advisory Opinion represents the only possible solution to the problems discussed or that it applies equally to seemingly similar situations. (emphasis added)

Mr McBurney's argument that a higher capitalization rate should be used is not supported by his exhibit 11, the Polton appraisal. Mr. Polton's appraisal arrived at a overall capitalization rate of 9.09% under the low-income scenario and 10.25% under the market rate scenario. The appraisal states:

In order to estimate the capitalization rate, we contacted the Montana Board of Housing and interviewed Robert Morgan and Maureen Rude. We ascertained that the low income housing developments developed during the period spanned by this report was provided by a variety

of conventional lenders. Specifically, several financings were arranged during 1994 based on rates of 8.25% to 9.5% on a twenty year amortization schedule. This is somewhat below conventional loans.

Mr. Polton's income approach under the low-income scenario is silent regarding the mortgage buy-down by HUD to 1% and that the term of the mortgage is 40 years.

A portion of the Advisory Opinion AO-14 states:

A critical factor in all subsidized housing appraisals is the analysis of whether or not the various subsidies, incentives and restrictions remain with the real property following a sale or foreclosure and are marketable property rights to be included in the appraisal.

Mr. McBurney testified that the mortgage arrangements along with the rent restrictions would remain with the property subsequent to a sale. It is the Board's opinion that the mortgage subsidy should be included in market value determination; therefore, the DOR's recognition of the mortgage subsidy is considered appropriate in valuing the subject property.

The letter of transmittal from the Polton appraisal (a Great Falls property) states:

...I have considered all of the factors that affect the value of the subject property and I am of the opinion the Tangible Value and Proper Assessment, as of January 1, 1994 is \$1,285,000...

DEFINITION OF MARKET VALUE

The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely

revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.

Fundamental assumptions and conditions presumed in this definition are:

1. Buyer and seller are motivated by self interest.
2. Buyer and seller are well-informed and are acting prudently.
3. The property is exposed for a reasonable time in the open market.
4. Payment is made in cash, its equivalent, or in other precisely revealed terms.
5. Specified financing, if any, may be the financing actually in place, or on terms generally available for the property type in its locale on the effective date of valuation.
6. The effect, if any, of atypical financing, services, or fees on the market value of the property shall be clearly and precisely revealed in the appraisal report.

#### FUNCTION OF THE APPRAISAL

This appraisal is intended to serve as the basis for a determination of market value of the tangible real estate in connection with a tax appeal. As such, it is prepared in accordance with all applicable report writing requirements and Standards of Professional Practice of the Appraisal Institute.

#### AFFORDABLE HOUSING

The subject property is affordable housing. Affordable Housing is defined as follows:

Affordable housing may be defines (sic) as single- or multi-family residential real estate targeted for ownership or occupancy by low- or moderate-income households as a result of public programs and other financial tools that assist or subsidize the developer, purchaser, or tenant in exchange for restrictions on use

and occupancy. The United States Department of Housing and Urban Development (HUD) provided the primary definition of income eligibility standard for low- and moderate-income households. Other federal, state and local agencies define income eligibility standards for specific programs and developments under their jurisdiction.

The subject property was developed under Section 236 program which subsidizes the interest payments of the mortgage loan and restricts occupancy to low income residents. The project is a limited dividend project and the returns on equity are limited to six percent of equity per annum, if available. The term of the restrictions on income have approximately twenty years remaining.

#### PROPERTY RIGHTS APPRAISED

The right or interest in the property being appraised is a fee simple estate. A fee simple estate is defined as follows:

□Absolute ownership unencumbered by any other interest or estate subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.□

Mr. Polton's appraisal has established a value for the property appraised in Exhibit #11 using the income approach by a "low income scenario" and a "market rate analysis". The final determination of value is that of the "low income scenario". This value takes into consideration the rent restrictions imposed on that property. It should be noted that the property rights appraised are fee simple which Mr. Polton has defined as unencumbered in his appraisal. It is the Board's opinion the value determination and the property rights appraised are not consistent in that appraisal.

The Court also instructed this Board to reflect how the governmental restrictions are factored into the valuation.

The Board has review the original record, evidence and testimony from the taxpayer's agent and from the DOR. It is the Board's opinion that the most credible evidence presented of income approach to value is that which The DOR presented: therefore, the correct value for the subject property is determined by the income approach, recognizing the necessity for allowance of actual rental income allowed, miscellaneous income, and an adjustment for the mortgage benefit to adjust for the HUD 236 Program. The management expense is adjusted to 11% to reflect higher costs subject to the regulations involved with the HUD 236 Program.

There was a voluntary element to the restrictions or encumbrances on behalf of the investors. The investors had a choice regarding whether to receive favorable mortgage benefits and other financial compensation, i.e. accelerated depreciation, developers fees, etc., in return for a limited-dividend. Investors in this property chose to waive market income in exchange for the favorable mortgage benefits at the time this property became part of the low income program. The DOR's method of valuing the mortgage subsidy indicates that there is

support for the value determined by the income approach. Because investors had a choice whether to accept restrictions or encumbrances in exchange for certain financial benefits, nothing was taken from the owner/investors for the benefit of others. It is the Board's opinion that the DOR's method of applying a value to the mortgage subsidy is sound.

Based on the evidence and testimony, it is the Board's opinion the market value for the subject property as determined by the income approach to value is \$1,350,737 as illustrated by the following:

Expenses(SF)	\$1.50	Management - 11%
Size (SF)	49,176	60 apt units
Apts Mo. Rent:	1 bedroom	12 \$225
	2 bedroom	36 \$275
	3 bedroom	12 \$317

#### **INCOME**

Monthly rental income	\$ 16,404
Income Adjustment	\$ 0
Total monthly rental income	\$ 16,404
Annualized	<u>X 12</u>
Total	\$196,848
Other income	\$ 6,398
Financing benefit	<u>\$ 46,504</u>
Potential Gross Income (PGI)	\$249,750
Occupancy	<u>100%</u>
Effective Gross Income (EGI)	\$249,750

#### **EXPENSES**

		%of EGI
Management	(\$ 27,473)	11%
Expenses	<u>(\$ 73,764)</u>	<u>30%</u>
Total Expenses	(\$101,237)	41%
Net Operating Income (NOI)	\$148,514	59%

#### **CAPITALIZATION**

Capitalization rate (OAR)	9.00%
Effective tax rate	<u>1.97%</u>
Total Rate	10.97%

<u>Value Indication</u>	<u>\$/per apt</u>
NOI / Total Rate = Value	
\$148,514 / 10.97% = \$1,350,737	\$22,512

### CONCLUSIONS OF LAW

1. **15-8-111, MCA**, Assessment - market value standard - exceptions. (1) All taxable property must be assessed at 100% of its market value except as otherwise provided.

(2) (a) Market value is the value at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

(b) If the department uses construction cost as one approximation of market value, the department shall fully consider reduction in value caused by depreciation, whether through physical depreciation, functional obsolescence, or economic obsolescence.

2. **15-1-101 MCA**, Definitions (1) Except as otherwise specifically provided, when terms mentioned in this section are used in connection with taxation, they are defined in the following manner:

(e) The term "comparable property" means property that:

(i) has similar use, function, and utility;

(ii) is influenced by the same set of economic trends and physical, governmental, and social factors; and

(iii) has the potential of a similar highest and best use.

(o) The term "property" includes money, credits, bonds, stocks, franchises, and all other matters and things, real, personal, and mixed, capable of private ownership. (emphasis supplied)

3. **15-6-101 MCA**, Property subject to taxation - classification. (1) All property in this state is subject to taxation, except as provide otherwise.

4. **ARM 42.20.107**, Valuation Methods for Commercial Properties.



(1) When determining the market value of commercial properties, other than industrial properties, department appraisers will consider, if necessary information is available, an income approach valuation.

(2) If the department is not able to develop an income model with a valid capitalization rate based on the stratified direct market analysis method, the band-of-investment method or collect sound income and expense data, the final value chosen for ad valorem tax purposes will be based on the cost approach to value. The final valuation is that which most accurately estimates market value.

5. **ARM 42.20.108**, Income Approach (1) The income approach is based on the theory that the value of income producing property is related to the amount, duration, and certainty of its income producing capacity. The formula used by the department to estimate the market value of income producing property through application of the income approach to value is  $V = I/R$  where:

(a)  $V$  is the value of the property to be determined by the department.

(b)  $I$  is the typical property net income for the type of properties being appraised; and

(c)  $R$  is the capitalization rate determined by the department as provided in ARM 42.20.109.

(2) The following procedures apply when valuing commercial property using the income approach:

(a) Typical property net income  $I$  shall reflect market rents not investment value income or other rents.

(b) Market rent is the rent that is justified for the property based on an analysis of comparable rental properties and upon past, present, and projected future rent of the subject property. It is not necessarily contract rent which is the rent actually paid by a tenant.

(c) The department will periodically request gross rental income and expense information from commercial property owners. Standard forms, developed by the department, will be used to collect the information statewide. Copies of those forms may be obtained by contacting the Department of Revenue, Property Assessment Division, Mitchell Building, Helena, Montana 59620.

(d) Additional methods of obtaining income and expenses information may consist of personal contacts or telephone contacts with owners, tenants, renters or leases,

knowledgeable lending institution officials, real estate brokers, fee appraisers, or any other sources the appraiser deems appropriate including summarized data from recognized firms who collect income and expense information, and appeal or court actions.

(e) The department will review and analyze all annual rental income and expense data collected. As necessary, that data will be adjusted to reflect average conditions and management before entering the data into the computer assisted mass appraisal system. The process must result in defensible estimates of potential gross rents, effective gross incomes, normal operating expenses, and normal net operating incomes.

(f) The department will follow established procedures for validating commercial sales information for the development of income models. Only valid sales will be used for the income and expense module of the computer assisted mass appraisal system.

(3) the department will use generally accepted procedures as outlined by the International Association of Assessing Officers in their titled "Property Assessment and Appraisal administration" when determining normal net operating income.

The following is an example of the format which will be used:

(a) potential gross rent  
    less        vacancy and collection loss  
    plus        miscellaneous income  
    equals      effective gross income  
    less        normal operating expenses  
    equals      normal net operating income

(b) Normal and allowable expenses include the cost of property insurance; heat, water, and other utilities; normal repairs and maintenance; reserves for replacement of items whose economic life will expire before that of the structure itself; management; and other miscellaneous item necessary to operate and maintain the property.

(c) Items which are not allowable expenses are depreciation charges, debt service, property taxes and business expenses other than those associated with the property being appraised.

(d) An effective tax rate will be included as part of the overall capitalization rate. (emphasis supplied)

6. **ARM 42.20.109**, Capitalization Rates (1) When using the income approach, the department will develop overall capitalization rates which may be according to use type,

location, and age of improvements. Rates will be determined by dividing the net income of each property in the group by its corresponding valid sale price. The overall rate chosen for each group is the median of the rates in the group. The final overall rate must include an effective tax rate.

(2) (a) If there are insufficient sales to implement the provisions of ARM 42.20.109 (1), the department will consider using a yield capitalization rate. The rate shall include a return of investment (recapture), a return on investment (discount), and an effective tax rate. The discount is developed using a band-of-investment method for types of commercial property. The band-of-investment method considers the interest rate that financial institutions lend on mortgages and the expected rate of return and average investor expects to receive on their equity. This method considers the actual mortgage rates and terms prevailing for individual types of property.

(b) A straight-line recapture rate and effective tax rate will be added to the discount rate to determine the yield capitalization rate.

**ORDER**

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the subject property shall be entered on the tax rolls of Missoula County by the Assessor of said County at the 1994 tax year and subsequent tax years within that appraisal cycle of the value reflective of the income approach value \$1,350,737 as determined by the Board.

Dated this 2nd of April, 1998.

BY ORDER OF THE  
STATE TAX APPEAL BOARD

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PATRICK E. McKELVEY, Chairman

(S E A L)

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GREGORY A. THORNQUIST, Member

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LINDA L. VAUGHEY, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

